



DOUCET ASSET MANAGEMENT, LLC

**Quarterly Newsletter**  
**Q3 2009**

DOUCET VALUE MOMENTUM PORTFOLIO  
DOUCET VALUE INCOME PORTFOLIO  
DOUCET MANAGED PORTFOLIO  
BIENVILLE MODEL

**July 2009**

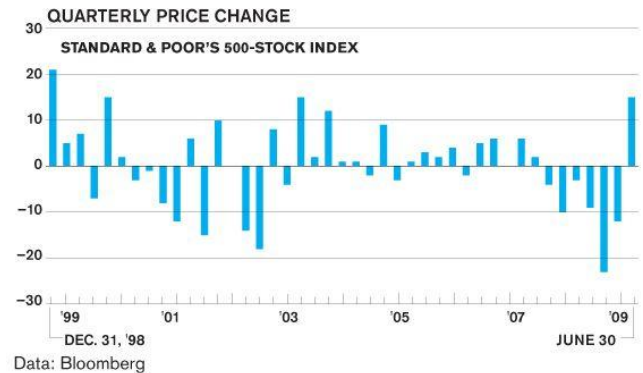
## **Above All, Do No Harm**

What a difference a couple hundred years can make. In 1776, the Continental Congress put themselves at significant risk, endangering their lives and property, for the good of the new nation by signing the Declaration of Independence. In contrast, today's 111<sup>th</sup> Congress has supported and passed measures which seem slanted more towards self-interest than the overall good of the nation. Some examples include an unprecedented government spending program – much of which will not promote growth – and outright disregard for contract law – senior bondholders “crammed down” in favor of auto unions – all in the name of “economic recovery.” In view of these actions, perhaps voters should require our public officials to adhere to some form of the “Hippocratic Oath,” traditionally pertaining to the ethical practice of medicine, which states, “Above all, do no harm.” The government’s desire to treat the symptoms of the economy and not the problems can now only cause more harm than good. What is now needed is *inaction* on spending and *action* on market structures which protect capital. The wildcard to our stabilization and recovery now is the U.S. government.

## **And There Has Been Harm**

In business, companies prepare detailed plans of action before committing capital. Washington apparently does not work that way. While we have said in past newsletters that it would have been “precisely wrong” for the government to have done nothing, we view much of the rescue of the financial system and economy as disjointed at best and more self-serving, pork-filled spending at worst. Even Elizabeth Warren, the Harvard law professor and head of Congressional oversight panel for the Troubled Asset Relief Program (TARP) funds, has publically stated she does not know where all of the money has gone. The special interest payoffs and transfer payments climaxed as Congress passed the American Recovery and Reinvestment Act of 2009 in February, better known as the \$787 billion stimulus plan. The S&P 500 Index reacted to these spending packages by declining to a 12-year low in early March, and the Confidence Board’s Consumer Confidence Index, a key measure of consumer sentiment, fell to its lowest level since the its inception in 1967.

Finally in March, the government began to discuss actions to ameliorate the structural flaws which intensified the meltdown of asset values. After simply talking about these problems, the market rallied... a lot! The S&P 500 Index has gained over 40% from its March 9<sup>th</sup> low. Part of this rebound, as a recent Barron’s article stated, could “simply be understood as a massively oversold market meeting profoundly underinvested investors enabled by a wave of liquidity.”



## “Green Shoots?”

While the idea that “green shoots” exist in the economy today requires a very optimistic interpretation of available information, there are definitely signs that things are significantly “less bad” than even a few weeks ago:

- Spreads between investment-grade corporates bonds and 30-year Treasury Bonds have narrowed from over 500 basis points in January 2009 to approximately 300 basis points today, according to Merrill Lynch U.S. Master Corporate Index, the narrowest spread since last August.
- The Volatility Index (VIX) has fallen to a 24 to 25 range, down from as high as 81 in November 2008, a sign of moderating investor anxiety.
- All stock market indices have rebounded significantly since March 2009. The S&P 500 Index just recorded its best quarter since 1998, up 15% in the three months ending June 30<sup>th</sup>.
- U.S. corporate bond sales reached a record annual rate of \$570.3 billion in the first quarter, the highest annual rate on record, as access to debt capital allowed companies to further strengthen balance sheets.
- Business inventories fell for the 9th straight month (as of July 2009). The manufacturing sector will be an important benefactor as companies begin to reorder.
- Consumers are deleveraging at a rapid pace as the Personal Savings Rate increased to almost 7% in May, the highest rate since December 1993. Personal Savings Rate was zero as recently as December 2007.
- As of July 23<sup>rd</sup>, 31% of S&P 500 companies have reported Q209 earnings: 72% reported higher quarterly earnings than analysts expected, albeit due largely to cost cutting versus revenue growth.
- The Treasury yield curve is significantly positively sloped which historically suggests a rapid improvement in the economy is expected.

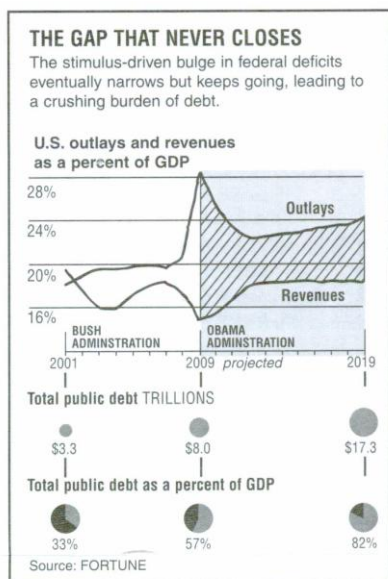
## Follow Through on Structure Rather Than Spending

Despite the abovementioned positive signs, it is disconcerting that as of the writing of this newsletter, the only structural issue the government has addressed to aid stability of the markets has been to relax FAS 157 or “mark-to-market accounting,” ...and only because they really did not have a choice. (It has been our opinion that, if left unchecked, this “weapon of financial mass destruction” could have driven every financial institution in America to insolvency.) In typical Washington fashion, every other issue – including the “uptick rule,” purchasing of troubled loans and regulating credit default swap markets (just to name a few) – has been, to this point, swept under the political rug.

Economic policies of both current and recently departed administrations are eerily reminiscent of those of Hoover and FDR in the 1930s. Specifically, too much of the focus has been on spending money rather than concentrating on the mechanisms which artificially inflate and deflate capital. FDR took a page from Keynesian Economics and flooded the market with stimulus, but failed to shut off the money spicket, prolonging the Great Depression. At the same time, he added the necessary market safeguards and structures much too slowly. Likewise, the Bush and Obama Administrations opened the floodgates of liquidity as the government has spent, loaned or committed more than \$13.2 trillion, making the current financial crisis the second most expensive single event in U.S. history behind World War II.

## The Gap That Never Closes

According to the U.S. Treasury’s website, total U.S. government debt held by the public is \$7.26 trillion as of July 23<sup>rd</sup>. *This is a 43.6% increase from only 2 years prior.* It gets worse though. Washington’s published number does not include the future obligations such as the debt related to government sponsored entities (such as Fannie Mae and Freddie Mac) and the pension-like obligations of entitlement programs (such as Social Security and Medicare) on its balance sheet. Today, it is estimated Fannie and Freddie would add another \$5.3 trillion to the liability side of the while the net present value of Social



Security and Medicare exceed \$46 trillion, according to the Government Accounting Office (GAO). If the government were a publicly-traded corporation, this additional massive debt load, especially combined with lower expected revenues, would result in downgraded credit rating and a falling stock price.

The nation is at an impasse. It cannot continue to run trillion dollar deficits and create entitlement programs for which it cannot possibly pay, without stifling current and crushing future growth with unserviceable debt levels. As detailed in the chart to the left, total receipts and total outlays have separated at an alarming rate, and even more disturbing, deficits are projected for the next 10 years. Recent history is replete with examples of countries – South Korea (1997), Malaysia (1998), Russia and Argentina (time and again) to name a few – whose mountainous debt eventually frightened global investors to the point they suddenly stopped lending. If expenditures and outlays are not reconciled soon, the only things separating the U.S. economy with some of the economies of the aforementioned countries is TIME.

### So, Where Do We Go From Here?

At this point, it is government action as well as inaction that will dictate the direction of the market and the economy. A few promising indications of inaction have been seen in the past several weeks including the federal government’s refusal to guarantee the State of California’s debt and the refusal to provide a bailout to lender CIT Group, prompting CIT bondholders to seek and successfully secure another source of emergency financing. Investors will interpret *inactions* like the aforementioned as a testament of perceived financial strength and discipline. The market has already noticed. In the past two weeks (since July 10<sup>th</sup>), the S&P 500 is up 11%.

Rising Treasury rates, declining corporate bond yields and firming in the equity markets all suggest money flows are venturing out on the investment risk curve as credit markets recover. We believe an attractive total return opportunity exists in securities which stand to benefit the most from improving credit markets in the short term, preferably offer some level of dividend and interest income. Equities, in general, should benefit during second quarter earnings season (mid July to mid August) from increasing book values due to mark-to-market accounting and rebounding commodity prices (from March 31<sup>st</sup> levels). The trend as companies report Q2 earnings will be revenues are lower than expected, but earnings will exceed analysts’ expectations due to cost cutting measures taken earlier in the year. Likewise, beginning in Q4 of this year, U.S companies should have an easier time surpassing the previous year’s earnings performance, potentially setting up a wave of positive headlines.

### Inflation: Not Likely In the Short-Term

Since the U.S. Federal Reserve appears to be emulating Zimbabwe with its current loose-money policies, it may seem counterintuitive not to be concerned with inflation in the near-term. One reason inflation may not be an immediate threat is unemployment. In economics, there exists a historical inverse relationship between the rate of unemployment and the rate of inflation in an economy, often described by the Phillips Curve. Chart 2 illustrates how inflation declines as unemployment rises and inflation rises as unemployment declines. The theory is that people have less money to spend when they are unemployed and the higher the unemployment the less goods and services will cost.



Unemployment is usually a lagging indicator because people start to lose their jobs *after* the economy has already declined. But since the end of 2008, with the considerable spike in unemployment, it has become more of a predictor of future economic conditions. Unemployment arrests consumption and triggers foreclosures. Continuing unemployment claims are now running at the highest level since the government began tracking the data in 1948. According to the article “Exit Strategy” in the July 6<sup>th</sup> edition of *Barron’s*, the real unemployment rate in America is more like 16.5% - not the published 9.5% - when including those working part-time when they need full-time employment and those who have stopped looking for employment.


When the recovery actually does begin to manifest itself, and it eventually will, what do you think employers are going to do? Hire new workers? Or give their current employees more hours? The latter, of course. Unemployment is likely to remain stubbornly high.

There is still much to be done. Improving flawed market structures in order to protect capital is the quickest (and most cost-effective) way to aid recuperating credit markets. The market has received its shock treatment. We hope the signs of inaction seen in the past few days are evidence the government is adopting a “Do No (further) Harm” philosophy.

## Firm News

We are very pleased to announce that our Analyst, David Ratliff, successfully completed the CFA Level III Exam, earning the Chartered Financial Analyst designation. Earning the charter required a dedicated effort over a minimum of three years to pass three six-hour examinations covering a globally relevant Body of Knowledge™ set by an international council of investment industry leaders. This is a significant achievement and we congratulate David on his continued development as an investment professional.

Sincerely,



Chris L. Doucet  
Chief Executive Officer

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- Form ADV: Please contact our office at (205) 414-9788 if you would like to receive a current copy of our Form ADV II or the Schedule H Brochure.
- Proxy Solicitations: If you receive calls regarding proxy voting, we suggest that you inform the caller that you have delegated Doucet Asset Management full authority to vote the proxy on your behalf. Please note that we are not able to prevent these calls from being placed to you directly.

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